Paper 1 (preliminary)

a) Title

Tying Yourself to the Mast: Painful Debt as a Commitment Device in Self-Fulfilling Debt Crises

b) abstract

Motivated by the recent looming debt crises in low-, and middle-income countries, this paper investigates why countries end up at a disadvantageous point of high debt and high economic costs of default. I propose that in normal times, governments may figuratively "tie themselves to the mast" by shifting to a debt portfolio that is more painful to restructure as this commits the government to repay. This reduces the probability of a liquidity crisis and allows governments to sustain higher debt levels but makes them vulnerable to large unanticipated economic shocks. Empirically, I find support for this commitment channel by exploiting high-frequency variation around a series of sovereign debt litigation outcomes. I find that a one percentage point increase in creditors' expected recovery rate reduces markets' beliefs about the likelihood of a default event over the next year by 0.27 percentage points. I then proceed to develop a debt crisis framework in which a government can issue two bonds that differ in how painful they are to restructure. I find that governments optimally use such a shift towards more painful debt portfolios to momentarily rule out liquidity crises and even permanently increase debt levels and the share of painful debt if hit by an adverse MIT shock to output.

c) web link where the paper can be downloaded

None (draft available soon, but not yet).

d) bibliographical reference in case the paper is accepted for publication

Not applicable (not yet published)

e) Details regarding conferences or seminars where the paper has been presented

The 96th International Atlantic Economic Conference (link)